PINNACLE WEST
CAPITAL CORPORATION
LAW DEPARTMENT

Thomas L. Mumaw
Senior Attorney
(602) 250-2052
Direct Line

June 25, 2009

Kristin K. Mayes, Chairman
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Re: Your Letter Dated June 9, 2009 Concerning Arizona Public Service Company's Pending Rate Case; Docket No. E-01345A-08-0172

Dear Chairman Mayes:

In your letter dated June 9th, you requested that certain issues or concerns be addressed by the Settling Parties. As was stated in the Staff's Notice of Filing Proposed Settlement Agreement, the Settlement Agreement itself addressed certain of the matters raised by your and other Commissioner letters in this docket. Issues not expressly addressed in the Settlement Agreement were discussed by the parties, and APS intends to provide a more in depth response in its testimony in support of the Settlement Agreement.[1] APS expects that other parties will also provide additional information on such issues in their testimony.

Question No. 1

The first concern expressed in the June 9th letter regards a statement made by Jim Hatfield, the Company's Chief Financial Officer, on a May 5, 2009 quarterly earnings call. As you are aware, the Settlement Agreement prevents APS from filing a new general rate case prior to June 1, 2011 and from filing a succeeding general rate case prior to June 1, 2013. These provisions are of great significance to all the Settling Parties, including APS. The provision, however, caused concern in the investment community. Concerns about any stay-out provision had been expressed to Mr. Hatfield by the investment community prior to the earnings call and were further expressed in the following exchange, a portion of which is quoted in your letter:

[1] Whether an issue raised by the June 9th letter was addressed to one extent or the other in the final Settlement Agreement, or is discussed in this letter, APS also intends to present testimony on each such issue.

Law Department, 400 North Fifth Street, Mail Station 8695, Phoenix, AZ 85004-3992
Phone: (602) 250-2052 · Facsimile (602) 250-3393
E-mail: Thomas.Mumaw@pinnaclewest.com

Paul Ridzon [Equity Analyst for KeyBanc]:

> How do you think about in the event that we see the return very quickly of robust growth, let's hope it happens, but to what extent do you think you've kind of locked yourself out of filing to get relief in that event? What provisions are there, if any, in the settlement that could kind of give you the opportunity for emergency relief?

Jim Hatfield:

> Well, I think if you look at it, the timing of our ability to file, we are not able to file any sooner than 6/1/11, so frankly, based on the settlement, we'll have the opportunity to file with the 2010 test year, and frankly, that's not a whole lot different than we would have had anyway.

Mr. Hatfield's comments did not express any pre-existing intention regarding when APS would have filed the next rate case. They were, instead, made in attempt to respond to the concerns of investors about the impact of any proposed stay-out provision, particularly should high rates of customer growth or other developments again adversely impact APS's financial metrics. In that context, Mr. Hatfield was simply noting that a 2010 test year would likely not be that different from a 2009 or earlier test year in capturing any return to robust growth in Arizona.

Absent the Settlement Agreement, APS would have immediately filed another rate case at the conclusion of the current proceeding, given its financial projections for 2011 and beyond. Further filings could, absent the provisions of the Settlement Agreement, have followed that 2010 rate case filing. The benefit to customers and other stakeholders gained by this provision of the Settlement Agreement is that it imposes a definitive schedule on APS general rate case filings that will respond to what would otherwise be a continuous cycle of rate cases from now through 2014. The limitations imposed by this schedule on APS materially restrict the Company's right and ability to file for additional future rate relief, and APS was able to agree to them only when balanced by other provisions in the Agreement.

Question No. 2

The second point raised in your letter is the 11% return on equity ("ROE") in the Settlement Agreement. This level of return was recommended by Staff in its direct testimony in this case. As noted in the Settlement Agreement, the 11% authorized return on equity is lower than the Company's requested equity return in this case and is also below that utilized by Arizonans for Electric Choice and

Law Department, 400 North Fifth Street, Mail Station 8695, Phoenix, AZ 85004-3992
Phone: (602) 250-2052 · Facsimile (602) 250-3393 · E-mail: Thomas.Mumaw@pinnaclewest.com

Competition for purposes of its recommendations in this proceeding. It is also below the level of returns being granted in other state jurisdictions.[2]

Moreover, an authorized ROE is never a guarantee of the earned ROE. And, it is the earned ROE, not the authorized ROE, to which investors primarily look when deciding where to invest their money. The returns APS will actually earn under the Settlement Agreement are far less than 11%, even in 2010—the first year new rates would be in effect. This was discussed extensively with the Settling Parties, and Mr. Hatfield will provide more information on this dynamic in his testimony. By the end of 2012, APS's earned return will have substantially declined, particularly as several provisions of the settlement providing earnings support expire at that time, thus making any longer rate case stay-out impossible.

Question No. 3

Next, you ask whether the Settling Parties considered the Commission's budgetary circumstances in reference to the requirement to process APS rate cases within 12 months of a sufficiency finding. The answer is yes, although hopefully the State's budget crisis will have been mitigated by then. The final Settlement Agreement only asks for a "good faith" effort to complete APS rate cases within 12 months of sufficiency, taking into consideration resource constraints of the Commission and other parties. It also incorporates additional pre-filing notification and additional filing requirements to aid in the Staff's review of the Company's application in a way that will improve the efficiency of the process, thus minimizing to the extent possible the burden on Staff resources.

Question No. 4

Fourth, you raise concerns and questions regarding Schedule 3. Other than the accounting treatment of the proceeds and some administrative improvements to the Schedule itself, the Settlement Agreement does not propose to change the line extension policy established by the Commission in the last APS rate case. The Settlement Agreement further acknowledges that the additional revenue anticipated from Schedule 3 is a very material aspect of the settlement, and that any changes to Schedule 3 must be revenue neutral to the settlement. Attached is an exhibit that addresses the revenue impact from different scenarios, which include those raised in your June 9th letter and some of those raised by other Commissioners in earlier letters in this docket. If a base rate change is used to make up for decreases in Schedule 3 revenues reflected in the scenarios above, each $5 million would require an increase in base rates of 0.17% or $0.20 for an average residential bill.

[2] These include: Alabama Power Company (14.5%), Entergy-Louisiana (11.1%), Entergy-New Orleans (11.05%), Georgia Power Company (12.25%), MidAmerican Energy (12%), NSTAR (12.5%), Pacific Gas & Electric (11.35%), Southern California Edison (11.5%) and Tampa Electric (11.25%). Several additional utilities have been granted an 11% ROE as would be allowed by the instant Settlement Agreement.

Law Department, 400 North Fifth Street, Mail Station 8695, Phoenix, AZ 85004-3992
Phone: (602) 250-2052 · Facsimile (602) 250-3393 · E-mail: Thomas.Mumaw@pinnaclewest.com

This same section of your June 9th letter further asks about the rate impacts, both short and long term, of treating Schedule 3 proceeds as revenues. In this Settlement Agreement, the rate impacts are to keep rates between $23 million and $48 million lower than would otherwise have been necessary, depending upon which year of the three year period 2010-2012 one is examining. Because Schedule 3 revenues grow over this period, this accounting change was critical to the ability of APS to agree to the Rate Case Filing Plan contained within the Settlement Agreement. Revenue treatment also has positive impacts on the Company's FFO/Debt ratio[3], while contributions in aid of construction ("CIAC") have precisely the opposite effect. That being said, it is true that if revenue treatment were continued for many years, it is possible that such revenue treatment of Schedule 3 proceeds could produce higher rates on a prospective basis in some future rate proceeding than had CIAC treatment been followed throughout. However, such a potential reversal of the current advantage to APS customers of revenue treatment would occur very far after the Settlement Agreement's termination of such revenue treatment in 2012 and would further have to assume that revenue treatment were readopted in the Company's next general rate case and continued after 2012 well into the future.[4]

Question No. 5

The next question raised by your letter is whether the utility scale solar facility referenced in the Term Sheet refers to the recently announced Starwood project. It does not. The required new facility is to be a photovoltaic resource and not a solar thermal generator such as Starwood. Such a photovoltaic resource would be consistent with the overall framework of the Company's current resource plan. However, the Settlement Agreement embodies an explicit commitment to pursue this facility rather than just a plan, and importantly provides the financial and regulatory support for APS to follow through on that commitment.

Question No. 6

You have also inquired about the in-state wind project also referenced in the Term Sheet. The final Settlement Agreement provides more details regarding this commitment. APS will submit such a project to the Commission within 180 days of issuing the RFP. APS intends to move forward with the project if approved by the Commission.

[3] Funds from operation as a percentage of total debt (FFO/Debt ratio) is a critical financial metric that significantly affects APS's debt ratings from Standard & Poor's and other rating agencies and thus affects APS's cost of financing new and existing investment.

[4] APS provided a detailed analysis of this issue in an October 24, 2007 letter to the Commission in Docket Nos. E-01345A-05-0816, E-01345A-05-0826 and E-01345A-05-0827 and will further address the matter in its Settlement Agreement testimony.

Law Department, 400 North Fifth Street, Mail Station 8695, Phoenix, AZ 85004-3992
Phone: (602) 250-2052 · Facsimile (602) 250-3393 · E-mail: Thomas.Mumaw@pinnaclewest.com

Question No. 7

Your seventh question asks whether the energy efficiency goals required by the Settlement Agreement are consistent with those being proposed by SWEEP in the generic energy efficiency docket. They are consistent over the period through 2012. These goals are also specifically designated by the Settlement Agreement as minimum requirements in that any more stringent standards resulting from the energy efficiency docket would supersede the Settlement Agreement, while less stringent provisions would not.

Question No. 8

In your eighth question, you inquire whether the Settling Parties believe it is in the public interest to adopt the RES as part of this case. In the Settlement Agreement, APS reiterates and renews its support of the current RES rules. Moreover, APS has agreed to abide by all of the renewable energy commitments set forth in the Settlement Agreement regardless of the outcome of any judicial challenge to the RES rules. The new renewable resources in the Settlement Agreement, combined with existing renewable energy commitments are projected to be approximately 10% of retail sales by the end of 2015. The Settlement Agreement does not mandate any specific level of commitment by APS in the year 2025, nor would it be appropriate to do so in isolation of other elements of the Settlement Agreement and independent of future RES rules requirements. It does, however, put APS on trajectory to exceed the overall requirements of the current RES rules and demonstrates a clear commitment to renewable energy.

Question No. 9

Ninth, you ask whether the Settling Parties believe it is in the public interest to require APS to adopt a feed-in tariff program for solar energy systems to encourage more rapid adoption of solar. Although APS is not opposed in principle to a properly designed feed-in-tariff pilot for small generation projects, it does not believe it is generally the most cost effective approach for APS customers. Discussion of feed-in tariffs would be more appropriate in the review and approval of the 2010 RES Implementation Plan, which will be filed July 1, 2009, as more parties potentially affected by such a policy will participate in that docket. The Settlement Agreement does not preclude Commission adoption of a feed-in-tariff pilot in APS's RES Implementation Plan. APS will more fully explain its rationale regarding this resource option in both the testimony of APS witness Barbara Lockwood in this docket and in its forthcoming RES Implementation Plan filing.

During your discussion of feed-in tariffs, you also inquire why the Settling Parties had not included Construction Work in Progress ("CWIP") for utility-owned renewable energy projects. As part of the Settlement Agreement, to encourage least cost renewable resources to benefit customers, APS can recover the capital carrying costs of any capital investments in renewable energy projects in one or more of the existing adjustor mechanism, as appropriate. This provision was added in-lieu of

Law Department, 400 North Fifth Street, Mail Station 8695, Phoenix, AZ 85004-3992
Phone: (602) 250-2052 · Facsimile (602) 250-3393 · E-mail: Thomas.Mumaw@pinnaclewest.com

CWIP and addresses the regulatory lag issue in a somewhat different but otherwise effective manner. APS will also further explain this aspect of the Settlement Agreement in its testimony.

Question No. 10

Lastly, you inquire about Renewable Energy Credits and the banking of carbon credits associated with the RES. You also ask about the establishment of a "carbon trust fund" associated with carbon credits generated by the RES. Carbon credits and other environmental attributes attributable to APS renewable energy already directly benefit all APS customers. APS believes that a carbon trust fund, which presumably would be formed separate from and outside of APS, would unnecessarily add another level of complexity and expense to what is likely to be a complicated process. As with other matters, APS will respond to this question more fully in the testimony of APS witness Barbara Lockwood.

Sincerely,

Thomas L. Mumaw

Thomas L. Mumaw
Attorney for Arizona Public Service Company

TLM/na

CC: Commissioner Gary Pierce
Commissioner Paul Newman
Commissioner Sandra D. Kennedy
Commissioner Bob Stump
Michael Kearns
Ernest Johnson
Janice Alward
Lyn Farmer
Parties of Record

APS • APS Energy Services • Pinnacle West Energy • SunCor • El Dorado

Law Department, 400 North Fifth Street, Mail Station 8695, Phoenix, AZ 85004-3992
Phone: (602) 250-2052 · Facsimile (602) 250-3393 · E-mail: Thomas.Mumaw@pinnaclewest.com

EXHIBIT A

ESTIMATED IMPACTS TO SETTLEMENT REVENUE LEVELS OF DIFFERING SCHEDULE 3 SCENARIOS FOR SINGLE RESIDENTIAL CUSTOMER LINE EXTENSIONS

	2010	2011	2012
Settlement with the modifications to Schedule 3 referenced therein.	$ 0	$ 0	$ 0
Scenario 1 – 1,000 ft free if under $25,000. Full amount paid if over $25,000.[1]	$5,960,000	$6,850,000	$10,000,000
Scenario 2 – Free footage if under $5,000/$10,000 (as applicable). Full amount paid if over $5,000/$10,000 (as applicable).			
50 ft. – up to $5,000	$ 580,000	$ 660,000	$ 960,000
100 ft. – up to $5,000	$ 600,000	$ 680,000	$ 990,000
500 ft. – up to $10,000	$ 2,760,000	$3,140,000	$ 4,550,000
750 ft. – up to $10,000	$ 2,800,000	$3,190,000	$ 4,600,000
Scenario 3 – Free footage approach subject to an investment cap.			
50 ft. but not more than $5,000	$ 2,600,000	$ 2,960,000	$ 4,280,000
100 ft. but not more than $5,000	$ 2,640,000	$ 3,000,000	$ 4,330,000
500 ft. but not more than $10,000	$ 4,815,000	$ 5,460,000	$ 7,850,000
750 ft. but not more than $10,000	$ 5,125,000	$ 5,800,000	$ 8,300,000
Scenario 4 - $5,000 equipment allowance.	$ 3,470,000	$3,860,000	$ 5,450,000

[1] This is the same line extension policy in existence prior to July 2007. Once an individual applicant's project exceeded $25,000 in estimated costs, it was no longer eligible for any free footage allowance regardless of the length of the extension.

Copies of the foregoing emailed or mailed
This 25th day of June 2009 to:

Ernest G. Johnson
Director, Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
ejohnson@cc.state.az.us

Maureen Scott
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
mscott@azcc.gov

Janet Wagner
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
jwagner@azcc.gov

Terri Ford
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
tford@azcc.gov

Barbara Keene
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
bKeene@cc.state.az.us

Daniel Pozefsky
Chief Counsel
RUCO
1110 West Washington, Suite 220
Phoenix, AZ 85007
dpozefsky@azruco.gov

William A. Rigsby
RUCO
1110 West Washington, Suite 220
Phoenix, AZ 85007
brigsby@azruco.gov

Tina Gamble
RUCO
1110 West Washington, Suite 220
Phoenix, AZ 85007
tgamble@azruco.gov

C. Webb Crockett
Fennemore Craig
3003 North Central, Suite 2600
Phoenix, AZ 85012-2913
wcrocket@fclaw.com

Kevin Higgins
Energy Strategies, LLC
215 South State Street, Suite 200
Salt Lake City, UT 84111
khiggins@energystrat.com

Michael L. Kurtz
Boehm, Kurt & Lowry
36 East Seventh Street, Suite 2110
Cincinnati, OH 45202
mkurtz@BKLlawfirm.com

Kurt J. Boehm
Boehm, Kurt & Lowry
36 East Seventh Street, Suite 2110
Cincinnati, OH 45202
kboehm@BKLlawfirm.com

The Kroger Company
Dennis George
Attn: Corporate Energy Manager (G09)
1014 Vine Street
Cincinnati, OH 45202
dgeorge@kroger.com

Stephen J. Baron
J. Kennedy & Associates
570 Colonial Park Drive
Suite 305
Roswell, GA 30075
sbaron@jkenn.com

Theodore Roberts
Sempra Energy Law Department
101 Ash Street, H Q 13D
San Diego, CA 92101-3017
TRoberts@sempra.com

Lawrence V. Robertson, Jr.
2247 E. Frontage Road
Tubac, AZ 85646
tubaclawyer@aol.com

Michael A. Curtis
501 East Thomas Road
Phoenix, AZ 85012
mcurtis401@aol.com

William P. Sullivan
501 East Thomas Road
Phoenix, AZ 85012
wsullivan@cgsuslaw.com

Larry K. Udall
501 East Thomas Road
Phoenix, AZ 85012
ludall@cgsuslaw.com

Michael Grant
Gallagher & Kennedy, P.A.
2575 East Camelback Road
Phoenix, AZ 85016
MMG@gknet.com

Gary Yaquinto
Arizona Investment Council
2100 North Central, Suite 210
Phoenix, AZ 85004
gyaquinto@arizonaic.org

David Berry
Western Resource Advocates
P.O. Box 1064
Scottsdale, AZ 85252-1064
azbluhill@aol.com

Tim Hogan
Arizona Center for Law in the Public Interest
202 East McDowell Road
Suite 153
Phoenix, AZ 85004
thogan@aclpi.org

Jeff Schlegel
SWEEP Arizona Representative
1167 W. Samalayuca Dr.
Tucson, AZ 85704-3224
schlegelj@aol.com

Jay I. Moyes
MOYES, SELLERS, & SIMS
1850 North Central Avenue, Suite 1100
Phoenix, AZ 85004
jimoyes@lawms.com

Jeffrey J. Woner
K.R. Saline & Assoc., PLC
160 N. Pasadena, Suite 101
Mesa, AZ 85201
jjw@krsaline.com

Scott Canty
General Counsel the Hopi Tribe
P.O. Box 123
Kykotsmovi, AZ 86039
Scanty0856@aol.com

Cynthia Zwick
1940 E. Luke Ave
Phoenix, AZ 85016
czwick@azcaa.org

Nicholas J. Enoch
349 North 4th Ave
Phoenix, AZ 85003
nick@lubinandenoch.com

Karen S. White, Esq
Air Force Utility Litigation &
Negotiation Team
AFLOA/JACL-ULT
139 Barnes Drive
Tyndall AFB, FL 32403
karen.white@tyndall.af.mil

Amanda Ormond
Interwest Energy Alliance
7650 S. McClintock
Suite 103-282
Tempe, AZ 85284
asormond@msn.com

Douglas V. Fant
Law Offices of Douglas V. Fant
3655 W. Anthem Dr.
Suite A-109 PMB 411
Anthem, AZ 85086
dfantlaw@earthlink.net

Barbara Wyllie-Pecora
27458 N. 129th Drive
Peoria, AZ 85383
bwylliepecora@yahoo.com

Carlo Dal Monte
Catalyst Paper Corporation
65 Front Street, Suite 201
Nanaimo, BC V9R 5H9
Carlo.dalmonte@catalystpaper.com

Steve Morrison
SCA Tissue North America
14005 West Old Hwy 66
Bellemont, AZ 86015
steve.morrison@sca.com